TERMS OF TRADE

1. The terms of trade for a country are the rate at which a country exchanges its exports for imports. Changes in terms of trade can be measured by the average prices of exports and the average prices of imports. It can also be defined as the ratio of exports prices to import prices
2. If the country's export price is cheap relative to its imports, then more goods would have to be exported by the country in order to purchase a given quantity of import. Terms of trade is said to worsen or become unfavorable.
3. Conversely if the export price increases relative to its import price, terms of trade is said to have improved because the country would be able to purchase a given quantity of import with a smaller quantity of export.

MEASUREMENT

To measure terms of trade, the formula used is:

$$\frac{\textbf{PRICE INDEX OR AVERAGE PRICE OF EXPORTS}}{\textbf{PRICE INDEX OR AVERAGE PRICE OF IMPORTS}} \times 100$$

CHANGES

What determines the change in the terms of trade of a country?

The fundamental factors that determine these changes are the changes in the demand and the changes in the supply conditions which determine the price. Thus,

1. Increase in the demand for imports will lead to unfavorable terms of trade
2. Increase in the supply of imports will lead to favorable terms of trade.
3. Increase in the supply of exports will lead to unfavorable terms of trade
4. Increase in the demand for export will lead to favorable terms of trade.

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Changes in demand conditions(ceteris paribus)

1. Changes in population will result in greater demand for foodstuffs. Prices of imported foodstuffs will increase and this would lead to the Malaysian government will impose a quota on Japanese and other imported cars.

2. An embargo, i.e. settings as total ban on the goods which are not allowed to be imported into the country occurs when countries have no political ties with one another or when the goods are considered socially undesirable and economically disruptive. Examples of embargoed goods are drugs, certain livestock's, pornographic material etc.
3. In exchange control, the amount of money that is allowed to be brought in or out of the country is fixed so the buying capacity is predetermined. A case in point is Australia where as a tourist one cannot leave country with more than 250$ in notes and $5 in coins in Australian currency.
4. Subsidies or grants such as the outright cash given to local producers by the government, i.e. aid to local industries will cause a fall in the cost of production and prices of local goods will decrease. As such, the demand for local goods will increase. This method is implemented in Malaysia where Malay padi planters are given aid in the form of technical assistance, fertilizers and sometimes machinery.
5. Preferential treatment is the granting of privileges to certain countries i.e. selected partners under the general agreement on Trade and tariffs (GATT). Here tariffs are reduced for member under the favored nation treatment, However if the reduction of tariffs is extended to one country, then it must also be offered to other members automatically. For example if Singapore reduces tariffs by 10% on Malaysian goods, it must grant the same reduction to Thailand as well. In practice this is not always workable.
6. The refusal to issue license to importers will lead to either embargo or quotas. Total imports will thus fall as importers find It difficult to obtain a license

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